

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:NER:PEN:PIT:TL-N-2677-99  
MAYost

date:

to: L.G. Fisher, Case Manager, PPG Audit

from: Associate District Counsel, Pennsylvania District, Pittsburgh

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subject: Excess Construction Costs

DISCLOSURE STATEMENT

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You have requested our advice on following issue:

ISSUE

Whether construction cost overruns borne by [REDACTED] to expand a [REDACTED] plant should be treated as capital contributions to a newly-formed limited liability company of which [REDACTED] was a [REDACTED] member, or as deductible business expenses under a construction contract entered into between [REDACTED] and the limited liability company.

ADVICE GIVEN

It can be argued, based upon the language of the operating agreement of the limited liability company, that the excess construction costs were required to be paid by [REDACTED] as part of its initial capital contribution to the company and, therefore, represent nondeductible capital contributions, rather than business expenses incurred by [REDACTED] as an independent contractor under a construction management contract and deductible pursuant to I.R.C. §§ 162 and 707.

However, the issue is essentially factual in nature, not free from doubt, and subject to moderate litigating hazards.

DISCUSSION

On [REDACTED], [REDACTED] and [REDACTED] formed [REDACTED], a [REDACTED] limited liability company, to own, operate, and maintain an expanded [REDACTED] plant to manufacture [REDACTED] ([REDACTED] plant). The [REDACTED] plant at the heart of the business venture was located at [REDACTED]'s [REDACTED] complex. The expansion project was to be completed by [REDACTED], with [REDACTED] acting as project manager under the terms of an Engineering and Construction Management Agreement.

According to an Operating Agreement entered into by [REDACTED] and [REDACTED], the initial capitalization of [REDACTED] was \$[REDACTED], which amount was to be fully paid at the time of formation of the company. [REDACTED] and [REDACTED] each were to contribute \$[REDACTED]. In addition, [REDACTED] agreed to pay [REDACTED] \$[REDACTED] in order to pay for the design and expansion of the [REDACTED] plant presently owned by [REDACTED] which was to be contributed by [REDACTED] to [REDACTED]. See section 4.02 of the Operating Agreement. [REDACTED]'s payment was governed by the terms and provisions of the Engineering and Construction Management Agreement. The Operating Agreement further provided that, for its part, [REDACTED] was to "contribute" the assets of its existing [REDACTED] plant and any costs or other expenses incurred in excess of \$[REDACTED] in designing and constructing the expanded [REDACTED] plant. Section 4.03(A)(1) and (2) of the Operating Agreement. The transfer of the [REDACTED] plant assets by [REDACTED] were not to take effect until the date that the plant expansion was commissioned (date when reactive chemicals introduced into the [REDACTED] plant in anticipation of start-up). Initially, [REDACTED] and [REDACTED] each held a [REDACTED]% interest in [REDACTED].

Section 4.03(A)(2) of the Operating Agreement also provided

that any excess construction costs contributed by [REDACTED] were taken into account in the determination of [REDACTED]'s basis in the assets of [REDACTED]. Such costs were considered as incurred by [REDACTED] for its own account or, "if not allowed as a loss," contributed to the company; however, they were not to be considered, in any event, as amounts paid to or for the benefit of [REDACTED] in the formation of the company and did not impact the sharing ratio (the ratio of that member's ownership interest in the company to the sum of the ownership interests of all members). Furthermore, such costs were not considered additional capital contributions for purposes of Sections 4.04 and 4.05 of the Operating Agreement.

Section 4.04 provided that the management committee of [REDACTED] may determine periodically that the company may require additional capital and give written notice to the members, who were then obligated to provide cash funding to meet the additional capital needs of the company within 30 days after the date of written notice. Section 4.05 provided that, in the event any member failed to timely make any required capital contribution, another member could make a substitute contribution and the sharing ratio would be adjusted.

The Operating Agreement additionally provided that [REDACTED] would establish a capital account for each member in accordance with Treas. Reg. §1.704-1(b)(2)(iv). Each account was to be increased by the amount of cash contributions made, by the agreed fair market value of property (net of liabilities assumed by the company or taken subject thereto) contributed, and by the amount of income and gain allocated to the member. The capital account was to be decreased by the amount of money or the fair market value of property distributed to each member, by that member's allocated share of company loss and deductions, and by any basis decreases required by the Code.

Under the Engineering and Construction Management Agreement, which was also dated [REDACTED], [REDACTED] assumed responsibility for managing all engineering, construction and commissioning aspects of the expansion of the [REDACTED] plant. The Agreement expressly provided that [REDACTED]'s status was that of an independent contractor. The \$[REDACTED] contributed by [REDACTED] to [REDACTED] was to be paid to [REDACTED] for the construction of the expanded [REDACTED] plant. [REDACTED] was to invoice [REDACTED] and that company, in turn, was to invoice [REDACTED] on a monthly basis for the cash costs of the project. [REDACTED] could issue additional invoices as needed in consultation with [REDACTED] to ensure that payments were equal to [REDACTED]'s cash costs incurred on the project. Upon completion of the work, [REDACTED] was to invoice [REDACTED] for the remainder, if any, of [REDACTED]'s \$[REDACTED] contribution

to the company. [REDACTED] was obligated to complete the expansion of the [REDACTED] plant to the extent that the cost of the expansion exceeded [REDACTED]'s \$[REDACTED] contribution, except for scope changes and extraordinary costs, which were to allocated between the parties.

[REDACTED] incurred excess construction costs exceeding the \$[REDACTED] contract price on the expanded [REDACTED] plant in the amounts of \$[REDACTED] in [REDACTED] and \$[REDACTED] in [REDACTED]. On its tax returns, [REDACTED] claimed these excess costs as ordinary deductions, contending that it realized a business loss to build the plant facility for [REDACTED] and [REDACTED] under a fixed price contract.

A Schedule K-1 for the tax year [REDACTED] reflected that [REDACTED] and [REDACTED] contributed cash to [REDACTED] during the year of \$[REDACTED] and \$[REDACTED], respectively. For [REDACTED], [REDACTED] contributed its [REDACTED] plant assets with a reported fair market value of \$[REDACTED]. [REDACTED] made cash contributions during [REDACTED] totaling \$[REDACTED]. The capital accounts of both [REDACTED] and [REDACTED] were each decreased by \$[REDACTED] to account for a net loss per books of \$[REDACTED]. At the end of [REDACTED], the capital accounts of [REDACTED] and [REDACTED] were in equal amounts of \$[REDACTED].

On [REDACTED], [REDACTED] received a ruling from the Service that [REDACTED] qualified as a partnership for federal income tax purposes.

Under I.R.C. § 721, a partner's contribution to a partnership in exchange for a partnership interest does not generally result in taxable gain or loss. The nonrecognition rule applies whether the contribution was made to the partnership in the process of formation or to one already formed and operating. Treas. Reg. § 1.721-1(a). However, I.R.C. § 721 does not apply to a transaction between a partnership and a partner not acting in his capacity as a partner, since such transaction is governed by I.R.C. § 707. In all cases, the substance of the transaction will govern rather than its form. Treas. Reg. § 1.721-1(a).

I.R.C. § 707(a) provides that, if a partner is engaged in a transaction with a partnership other than in his capacity as a partner, which would be the case if the partner was acting as an independent contractor, the transaction would generally be considered as occurring between the partnership and one who is not a partner. Again, in all cases, the substance of the transaction governs rather than its form. Treas. Reg. § 1.707-1(a). The treatment of the partnership transaction as one

involving an outsider, rather than a partner, subjects the transaction to the normal tax rules applicable to transactions between unrelated parties in lieu of the special rules for transactions between a partner and his partnership.

The determination of whether the cost overruns on the construction of the expanded [REDACTED] plant were nondeductible capital contributions by [REDACTED] to [REDACTED] is a question of fact. See, Schmidt v. Commissioner, T.C. Memo 1983-612; Otey v. Commissioner, 70 T.C. 312 (1978), aff'd, 634 F.2d 1046 (6<sup>th</sup> Cir. 1980). As such, the analysis in this case starts with the provisions of the Operating Agreement for [REDACTED]. The Exam team correctly points out that section 4.03(A)(1) and (2) of the Operating Agreement specifically provide that [REDACTED]'s initial capital obligations to [REDACTED] included both the existing [REDACTED] plant assets and "any costs or other expenses incurred in excess of \$[REDACTED] in designing and constructing the expanded [REDACTED] plant. This provision clearly evinces that the parties intended the cost overruns to be part of [REDACTED]'s capital contribution to [REDACTED]. The language in the Operating Agreement indicating that any excess costs borne by [REDACTED] were not to be considered additional capital contributions for purposes of section 4.04 and 4.05 of the Operating Agreement is not inconsistent. We interpret this language as merely clarifying that the cost overruns were part of [REDACTED]'s initial capital contributions and were not to be deemed "additional" contributions for which 30 days written notice had to be provided by the management committee of [REDACTED].

Furthermore, the obligation of [REDACTED] to manage the expansion of the [REDACTED] plant for a fixed sum of \$[REDACTED] under the Engineering and Construction Management Agreement is not separate and distinct from the formation of [REDACTED] and the parties' initial capital obligations under the Operating Agreement. The agreements are interwoven and should not be construed as separate transactions imposing upon the parties entirely distinct obligations. The substance of the arrangement may well be that [REDACTED] was, in essence, acting in its capacity as a partner to oversee the construction management of the [REDACTED] plant expansion and expenditure of company funds to finance the project. The timing of [REDACTED]'s \$[REDACTED] capital contribution to [REDACTED] was expressly governed by the terms and provisions of the Engineering and Construction Management Agreement. Also, both agreements envisioned that [REDACTED] had to bear construction costs in excess of [REDACTED]'s initial capital contribution, with such costs being considered as part of [REDACTED]'s initial required contribution under the Operating Agreement.

However, as previously noted, the issue is essentially

factual in nature and not free from doubt. There are certainly litigating hazards in going forward. For one thing, the credit which [REDACTED] received on the books of [REDACTED] for the contribution of a nominal amount of cash and the fair market value of its [REDACTED] plant assets equalized that given to [REDACTED] for its cash contribution of \$[REDACTED]. This signifies that the respective capital contributions of the parties were equal in value, without taking into account any excess construction costs borne by [REDACTED]. Under the capital maintenance rules of Treas. Reg. § 1.704-1(b)(iv), [REDACTED]'s capital account would be increased by the excess costs that it paid. Unless the fair market value of the [REDACTED] plant assets was overstated, reclassification of the cost overruns as capital contributions will tip the agreed upon economic equivalence of the parties' capital accounts. Under the Operating Agreement, [REDACTED] is not to receive any increase to its profit or capital interest on account of payment of the excess costs. Finally, [REDACTED] argues that had it reported a profit on the contract, rather than a loss, such profit would have been taxed as ordinary income under the contract and not as a partnership distribution from [REDACTED].

If you have any questions, please call Michael A. Yost, Jr. of this office at ext. 3441.

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EDWARD F. PEDUZZI, JR.  
Associate District Counsel